

additional allowance. If for a taxable year beginning after December 31, 1969, the total short-term capital losses carried to such year from taxable years beginning before January 1, 1970, as provided by § 1.1212-1(b) and this subdivision exceed the sum of:

(a) The portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net short-term capital gain actually realized in the taxable year, plus

(b) The amount by which the portion of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) actually realized in the taxable year (i.e., computed without regard to capital losses carried to the taxable year) which consists of net long-term capital gain actually realized in the taxable year exceeds the total long-term capital losses carried to the taxable year from taxable years beginning before January 1, 1970, as provided in § 1.1212-1(b) and subdivision (iii) of this subparagraph,

then such excess shall constitute the *transitional net short-term capital loss component* for the taxable year, and to the extent such component also exceeds the net short-term capital loss applied to the additional allowance (as provided in subparagraphs (2) and (4)(i) of this paragraph) or the transitional additional allowance (as provided by subdivision (i) of this subparagraph and subparagraph (4)(i) of this paragraph) for the taxable year shall be carried to the succeeding taxable year as short-term capital losses from taxable years beginning before January 1, 1970, for utilization in such succeeding taxable year in the computation of the additional allowance (as provided by subparagraph (2) of this paragraph) or the transitional additional allowance (as provided by subdivision (i) and (ii) of this subparagraph). In no event, however, shall the amount of such component so carried to the following taxable year as otherwise provided by this subdivision exceed the total of net short-term capital losses actually carried to such succeeding taxable year pursuant to section 1212(b) and § 1.1212-1(b).

(v) *Scope of rules.* The rules provided by this subparagraph are for the purpose of computing the amount of the transitional additional allowance deductible for the taxable year pursuant to the provisions of section 1212(b)(3) and this subparagraph. More specifically, their operation permits the limited use of a long-term capital loss carried to the taxable year from a taxable year beginning before December 31, 1969, in full on a dollar-for-dollar basis in computing the transitional additional allowance deductible for the taxable year. These rules have no application to, or effect upon, a determination of the character or amount of capital gain net income (net capital gain for taxable years beginning before January 1, 1977) reportable in the taxable year. See paragraph (b)(1) of this section and § 1.1212-1 for the determination of the amount and character of capital gains and losses reportable in the taxable year. Further, except to the extent that their application may affect the amount of the transitional additional allowance deductible for the taxable year and thus the amount to be treated as short-term capital loss for carryover purposes under section 1212(b) and § 1.1212-1(b)(2), these rules have no effect upon a determination of the character or amount of capital losses carried to or from the taxable year pursuant to section 1212(b) and § 1.1212-1(b).

(4) *Order of application of capital losses to additional allowance or transitional additional allowance.* In applying the excess of the net short-term capital loss over the net long-term capital gain and the excess of the net long-term capital loss over the net short-term capital gain to the additional allowance or transitional additional allowance deductible under section 1211(b) and this paragraph, such excesses shall, subject to the limitations of subparagraph (2) or (3) of this paragraph, be used in the following order:

(i) First, there shall be applied to the additional allowance or transitional additional allowance the excess, if any, of the net short-term capital loss over the net long-term capital gain.

(ii) Second, if such transitional additional allowance exceeds the amount so applied thereto as provided in subdivision (i) of this subparagraph, there

shall next be applied thereto as provided in subparagraph (3) of this paragraph the excess, if any, of the net long-term capital loss over the net short-term capital gain to the extent of the transitional net long-term capital loss component for the taxable year computed as provided by subdivision (ii) of subparagraph (3) of this paragraph.

(iii) Third, if such additional allowance or transitional additional allowance exceeds the sum of the amounts so applied thereto as provided in subdivisions (i) and (ii) of this subparagraph, there shall be applied thereto one-half of the balance, if any, of the excess net long-term capital loss not applied pursuant to the provisions of subdivision (ii) of this subparagraph.

(5) *Taxable years beginning prior to January 1, 1970.* For any taxable year beginning prior to January 1, 1970, subparagraphs (2) and (3) of this paragraph shall not apply and losses from sales or exchanges of capital assets shall be allowed as a deduction only to the extent of gains from such sales or exchanges, plus (if such losses exceed such gains) the taxable income of the taxpayer or \$1,000, whichever is smaller.

(6) *Special rules.* (i) For purposes of section 1211(b) and this paragraph, taxable income is to be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. For example, the deductions available to estates and trusts under section 642(b) are in lieu of the deductions allowed under section 151, and, in the case of estates and trusts, are to be added back to taxable income for the purposes of section 1211(b) and this paragraph.

(ii) For taxable years beginning before January 1, 1976, in case the tax is computed under section 3 and the regulations thereunder (relating to optional tax tables for individuals), the term *taxable income* as used in section 1211(b) and this paragraph shall be read as *adjusted gross income*.

(iii) In the case of a joint return, the limitation under section 1211(b) and this paragraph, relating to the allowance of losses from sales or exchanges

of capital assets, is to be computed and the net capital loss determined with respect to the combined taxable income and the combined capital gains and losses of the spouses.

(7) *Married taxpayers filing separate returns*—(i) *In general.* In the case of a husband or a wife who files a separate return for a taxable year beginning after December 31, 1969, the \$3,000, \$2,000, and \$1,000 amounts specified in subparagraphs (2)(ii) and (3)(i)(b) of this paragraph shall instead be \$1,500, \$1,000, and \$500, respectively.

(ii) *Special rule.* If, pursuant to the provisions of § 1.1212-1(b) and subparagraph (3) (iii) or (iv) of this paragraph, there is carried to the taxable year from a taxable year beginning before January 1, 1970, a short-term capital loss or a long-term capital loss, the \$1,500, \$1,000 and \$500 amounts specified in subdivision (i) of this subparagraph shall instead be maximum amounts of \$3,000, \$2,000, and \$1,000 respectively, equal to \$1,500, \$1,000, and \$500, respectively, plus the total of the transitional net long-term capital loss component for the taxable year computed as provided by subparagraph (3)(ii) of this paragraph and the transitional net short-term capital loss component for the taxable year computed as provided by subparagraph (3)(iv) of this paragraph.

(8) *Examples.* The provisions of section 1211(b) may be illustrated by the following examples:

Example 1. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses	\$4,400
Deduction provided by section 151	625
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Taxable income for purposes of section 1211(b) ..	5,025
Long-term capital gain	\$1,200
Long-term capital loss	(5,300)
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Net long-term capital loss	(4,100)
Losses to the extent of gains	(1,200)
Additional allowance deductible under section 1211(b)	1,000
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The net long-term capital loss of \$4,100 is deductible in 1970 only to the extent of an additional allowance of \$1,000 which is smaller than the taxable income of \$5,025. Under section 1211(b) and subparagraph (2) of this paragraph, \$2,000 of excess net long-term capital loss was required to produce the \$1,000 additional allowance. Therefore, a net long-term capital loss of \$2,100 (\$4,100 minus \$2,000) is carried over under section 1212(b) to the succeeding taxable year. If A had the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions in 1977, the additional allowance would be \$2,000, and a net long-term capital loss of \$100 would be carried over. For a taxable year beginning in 1978 or thereafter, these facts would give rise to a \$2,050 additional allowance and no carry-over.

Example 2. B, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses	\$90
Deduction provided by section 151	625
Taxable income for purposes of section 1211(b) ..	715
Long-term capital gain	\$1,200
Long-term capital loss	(5,200)
Net long-term capital loss	(4,000)
Losses to the extent of gains	(1,200)
Additional allowance deductible under section 1211(b)	715

The net long-term capital loss of \$4,000 is deductible in 1970 only to the extent of an additional allowance of \$715, since the \$715 of taxable income for purposes of section 1211(b) is smaller than \$1,000. Under section 1211(b) and subparagraph (2) of this paragraph, \$1,430 of net long-term capital loss was required to produce the \$715 additional allowance. Therefore, a net long-term capital loss of \$2,570 (\$4,000 minus \$1,430) is carried over under section 1212(b) to the succeeding taxable year. For illustration of the result if the net capital loss for the taxable year is smaller than both \$1,000 and taxable income for the purposes of section 1211(b), see examples (3) and (4) of this subparagraph. For carry-over of a net capital loss, see § 1.1212-1. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the same result would be reached.

Example 3. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1971:

Taxable income exclusive of capital gains and losses	\$13,300
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Deduction provided by section 151	675
Taxable income for purposes of section 1211(b) ..	13,975
Long-term capital gain	\$400
Long-term capital loss	(\$600)
Net long-term capital loss	(200)
Short-term capital gain	900
Short-term capital loss	(1,400)
Net short-term capital loss	(500)
Losses to extent of gains	(1,300)
Additional allowance deductible under section 1211(b)	\$600

The \$600 additional allowance deductible under section 1211(b) is the least of: (i) Taxable income of \$13,975, (ii) \$1,000, or (iii) the sum of the excess of the net short-term capital loss of \$500 over the net long-term capital gain, plus one-half of the excess of the net long-term capital loss of \$200 over the net short-term capital gain. The \$600 additional allowance, therefore, consists of the net short-term capital loss of \$500, plus \$100 (one-half of the net long-term capital loss of \$200), the total of which is smaller than both \$1,000 and taxable income for purposes of section 1211(b). No amount of net capital loss remains to be carried over under section 1212(b) to the succeeding taxable year since the entire amount of the net short-term capital loss of \$500 plus the entire amount of the net long-term capital loss of \$200 required to produce \$100 of the deduction was absorbed by the additional allowance deductible under section 1211(b) for 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the result would remain unchanged.

Example 4. A, a married individual filing a separate return with one exemption allowable as a deduction under section 151, has the following transactions in 1971:

Taxable income exclusive of capital gains and losses	\$12,000
Deduction provided by section 151	675
Taxable income for purposes of section 1211(b) ..	12,675
Long-term capital loss	(\$800)
Long-term capital gain	300
Net long-term capital loss	(500)
Short-term capital loss	(500)
Short-term capital gain	600
Net short-term capital gain	100
Losses to the extent of gains	(900)
Additional allowance deductible under section 1211(b)	200

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The excess net long-term capital loss of \$400 (net long-term capital loss of \$500 minus net short-term capital gain of \$100) is deductible in 1971 only to the extent of an additional allowance of \$200 (one-half of \$400) which is smaller than both \$500 (married taxpayer filing a separate return for a taxable year beginning after December 31, 1969) and taxable income for purposes of section 1211(b). Since there is no net short-term capital loss in excess of net long-term capital gains for the taxable year, the \$200 additional allowance deductible under section 1211(b) consists entirely of excess net long-term capital loss. No amount of net capital loss remains to be carried over under section 1212(b) to the succeeding taxable year. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the result would remain unchanged.

Example 5. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses	\$13,300
Deduction provided by section 151	625
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Taxable income for purposes of section 1211(b) ..	13,925
Long-term capital loss	(\$6,000)
Long-term capital gain	2,000
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Net long-term capital loss	(4,000)
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Short-term capital gain	3,000
Short-term capital loss carried to 1970 from 1969 under section 1212(b)(1)	(3,000)
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Net short-term capital loss	0
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Losses to the extent of gains	(5,000)
Additional allowance deductible under section 1211(b)	1,000
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The \$1,000 additional allowance deductible under section 1211(b) is the least of (i) taxable income of \$13,925, (ii) \$1,000, or (iii) the sum of the net short-term capital loss (\$0) plus one-half of the net long-term capital loss of \$4,000. The \$1,000 additional allowance, therefore, consists of net long-term capital loss. Since \$2,000 of the net long-term capital loss of \$4,000 was required to produce the \$1,000 additional allowance, the \$2,000 balance of the net long-term capital loss is carried over under section 1212(b) to 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the additional allowance would be \$2,000, and there would be no carry-over.

Example 6. A, an unmarried individual with one exemption allowable as a deduction

under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses	\$13,300
Deduction provided by section 151	625
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Taxable income for purposes of section 1211(b) ..	13,925
Long-term capital gain	\$5,000
Long-term capital loss	(7,000)
Long-term capital loss carried to 1970 from 1969 under section 1212 (b)(1)	(500)
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Net long-term capital Loss	(2,500)
Short-term capital gain	1,100
Short-term capital loss	(1,400)
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Net short-term capital loss	(300)
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Losses to extent of gains	(6,100)
Transitional additional allowance deductible under section 1211(b)	1,000
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Because a component of the net long-term capital loss for 1970 is a \$500 long-term capital loss carried to 1970 from 1969, the transitional additional allowance deductible under section 1211(b) and subparagraph (3) of this paragraph is the least of (i) taxable income of \$13,925, (ii) \$1,000 or (iii) the sum of the net short-term capital loss of \$300, plus the net long-term capital loss for 1970, to the extent of the \$500 long-term capital loss carried to 1970 from 1969 and one-half of the \$2,000 balance of the net long-term capital loss. The entire \$500 long-term capital loss carried to 1970 from 1969 is applicable in full to the transitional additional allowance because there was no net capital gain (capital gain net income for taxable years beginning after December 31, 1976) actually realized in 1970. The \$1,000 transitional additional allowance, therefore, consists of the net short-term capital loss of \$300, the \$500 long-term capital loss carried to 1970 from 1969, plus one-half of enough of the balance of the 1970 net long-term capital loss (\$400) to make up the \$200 balance of the \$1,000 transitional additional allowance. A long-term capital loss of \$1,600 (\$2,500 minus \$900), all of which is attributable to 1970, is carried over under section 1212(b) to 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the transitional additional allowance would be \$1,800. No amount would remain to be carried over to the succeeding taxable year.

Example 7. A, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1970:

Taxable income exclusive of capital gains and losses	\$13,300
Deduction provided by section 151	625
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Taxable income for purposes of section 1211(b) ..	13,925
Long-term capital loss	(2,000)
Long-term capital loss carried to 1970 from 1969 under section 1212 (b)(1)	(500)
Net long-term capital loss	(2,500)
Short-term capital gain	2,600
Short-term capital loss carried to 1970 from 1969 under section 1212 (b)(1)	(3,000)
Net short-term capital loss	(400)
Losses to the extent of gains	(2,600)
Transitional additional allowance deductible under section 1211(b)	1,000

Because a component of the net long-term capital loss for 1970 is a \$500 long-term capital loss carried to 1970 from 1969, the transitional additional allowance deductible under section 1211(b) and subparagraph (3) of this paragraph is the least of (i) taxable income of \$13,925, (ii) \$1,000, or (iii) the sum of the net short-term capital loss of \$400, plus the net long-term capital loss for 1970 to the extent of the \$500 long-term capital loss carried to 1970 from 1969, and one-half of the \$2,000 balance of the net long-term capital loss. The entire \$500 long-term capital loss carried to 1970 from 1969 is applicable in full to the transitional additional allowance because the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for the taxable year (computed without regard to capital losses carried to the taxable year) consisted entirely of net short-term capital gain not in excess of the short-term capital loss carried to 1970 from 1969. The \$1,000 transitional additional allowance, therefore, consists of the net short-term capital loss of \$400, the \$500 long-term capital loss carried to 1970 from 1969, plus one-half of enough of the balance of the 1970 net long-term capital loss (\$200) to make up the \$100 balance of the \$1,000 transitional additional allowance. A long-term capital loss of \$1,800 (\$2,500 minus \$700), all of which is attributable to 1970, is carried over under section 1212(b) to 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for taxable years beginning in 1977 or thereafter, the transitional additional allowance would be \$1,900. No amount would remain to be carried over to the succeeding taxable year.

Example 8. Assume the facts in Example (7) but assume that the individual with one exemption allowable as a deduction under section 151 is married and files a separate return for 1970. The maximum transitional additional allowance to which the individual would be entitled for 1970 pursuant to subparagraph (7)(ii) of this paragraph would be

the sum of \$500 plus (i) \$2,400 of the short-term capital loss of \$3,000 carried to 1970 from 1969 (the amount by which such carry-over exceeds the \$600 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) actually realized in 1970, all of which is net short-term capital gain) and (ii) the \$500 long-term capital loss carried to 1970 from 1969. However, since this sum (\$3,400) exceeds \$1,000, the maximum transitional additional allowance to which the individual is entitled for 1970 is limited to \$1,000. If for 1971, the same married individual had taxable income of \$13,925 for purposes of section 1211(b) and no capital transactions, and filed a separate return, the additional allowance deductible under section 1211(b) for 1971 would be limited to \$500 by reason of subdivision (i) of subparagraph (7) of this paragraph, since, as illustrated in Example 7, no part of the capital loss carried over to 1971 under section 1212 (b) is attributable to 1969. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions as in example (7) for a married individual filing a separate return for a taxable year beginning in 1977 or thereafter, the transitional additional allowance would be \$1,900. No amount would remain to be carried over to the succeeding taxable year.

Example 9. B, an unmarried individual with one exemption allowable as a deduction under section 151, has the following transactions in 1971:

Taxable income exclusive of capital gains and losses	\$10,000
Deductions provided by section 151	675
Taxable income for purposes of section 1211(b) ..	10,675
Long-term capital gain	\$2,500
Long-term capital loss treated under § 1.1211-1 (b)(3)(iii) as carried over from 1969	(5,000)
Net long-term capital loss	(2,500)
Short-term capital gain	2,700
Short-term capital loss carried to 1971 from 1970 under section 1212 (b)(1)	(1,000)
Short-term capital loss treated under § 1.1211-1 (b)(3)(iv) as carried over from 1969	(2,000)
Net short-term capital loss	(300)
Losses to extent of gain	(5,200)
Transitional additional allowance deductible under section 1211(b)	1,000

Because a component of the net long-term capital loss for 1971 is a long-term capital loss treated under subparagraph (3)(iii) of this paragraph as carried over from 1969, the rules for computation of the transitional additional allowance under subparagraph (3) (i) and (ii) of this paragraph apply. The *transitional net long-term capital loss component* for 1971 under subparagraph (3)(ii) of this paragraph is \$1,800, that is, the amount by which the \$5,000 long-term loss treated as carried over from 1969 to 1971 exceeds (a) the net long-term capital gain of \$2,500 actually realized in 1971 plus (b) the \$700 excess of the \$2,700 net short-term capital gain actually realized in 1971 over the \$2,000 short-term capital loss treated as carried over to 1971 from 1969. The transitional additional allowance for 1971 consists of the \$300 net short-term capital loss plus \$700 of the net long-term capital loss attributable to 1969. A net long-term capital loss of \$1,800 (\$2,500 minus \$700) is carried over to 1972 under section 1212(b). Only \$1,100 of the \$1,800 will be treated in 1972 as carried over from 1969 since under subparagraph (3)(iii) of this paragraph the *transitional net long-term capital loss component* of \$1,800 is reduced by the amount (\$700) applied to the transitional additional allowance for 1971. Assuming the same taxable income for purposes of section 1211(b) (after reduction by the zero bracket amount) and the same transactions for a taxable year beginning in 1977, the transitional additional allowance would be \$2,000. A net long-term capital loss of \$800 would remain to be carried over. Of this amount \$100 would be treated as carried over from 1969. Assuming the original facts for a taxable year beginning in 1978, the transitional additional allowance would be \$2,450. No amount would remain to be carried over to the succeeding taxable year.

[T.D. 7301, 39 FR 964, Jan. 4, 1974; 39 FR 2758, Jan. 24, 1974, as amended by T.D. 7597, 44 FR 12419, Mar. 7, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1212-1 Capital loss carryovers and carrybacks.

(a) *Corporations; other taxpayers for taxable years beginning before January 1, 1964—*(1) *Regular net capital loss sustained for taxable years beginning before January 1, 1970.* (i) A corporation sustaining a net capital loss for any taxable year beginning before January 1, 1970, and a taxpayer other than a corporation sustaining a net capital loss for any taxable year beginning before

January 1, 1964, shall carry over such net loss to each of the 5 succeeding taxable years and treat it in each of such 5 succeeding taxable years as a short-term capital loss to the extent not allowed as a deduction against any net capital gains (capital gain net income for taxable years beginning after December 31, 1976) of any taxable years intervening between the taxable year in which the net capital loss was sustained and the taxable year to which carried. The carryover is thus applied in each succeeding taxable year to offset any net capital gain in such succeeding taxable year. The amount of the capital loss carryover may not be included in computing a new net capital loss of a taxable year which can be carried over to the next 5 succeeding taxable years. For purposes of this subparagraph, a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) shall be computed without regard to capital loss carryovers or carrybacks. In the case of nonresident alien individuals, see section 871 for special rules on capital loss carryovers. For the rules applicable to the portion of a net capital loss of a corporation which is attributable to a foreign expropriation capital loss sustained in taxable years beginning after December 31, 1958, see subparagraph (2) of this paragraph. For the rules applicable to a taxpayer other than a corporation in the treatment of that amount of a net capital loss which may be carried over under section 1212 and this subparagraph as a short-term capital loss to the first taxable year beginning after December 31, 1963, see paragraph (b) of this section.

(ii) The practical operation of the provisions of this subparagraph may be illustrated by the following example:

Example. (a) For the taxable years 1952 to 1956, inclusive, an individual with one exemption allowable under section 151 (or corresponding provision of prior law) is assumed to have a net short-term capital loss, net short-term capital gain, net long-term capital loss, net long-term capital gain, and taxable income (net income for 1952 and 1953) as follows:

	1952	1953	1954	1955	1956
Carryover from prior years:					
From 1952		(\$50,000)	(\$29,500)	(\$29,500)

	1952	1953	1954	1955	1956
From 1954				(19,500)	(\$13,000)
Net short-term loss (computed without regard to the carryovers)	(\$30,000)	(5,000)	(10,000)		
Net short-term gain (computed without regard to the carryovers)				40,000	
Net long-term loss	(20,500)		(10,000)	(5,000)	
Net long-term gain		25,000			15,000
Net income or taxable income, computed without regard to capital gains and losses, and, after 1953, without regard to the deduction provided by section 151	500	500	500	1,000	500
Net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (computed without regard to the carryovers)		20,500		36,000	
Net capital loss	(50,000)		(19,500)		
Deduction allowable under section 1202 ..					1,000
Taxable income (after deductions allowable under sections 151 and 1202)					900

(b) *Net capital loss of 1952.* The net capital loss is \$50,000. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains (in this case, none) from sales or exchanges of capital assets, and (2) net income (computed without regard to capital gains and losses) of \$500. This amount may be carried forward in full as a short-term loss to 1953. However, in 1953 there was a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of \$20,500, as defined by section 117(a)(10)(B) of the Internal Revenue Code of 1939, and limited by section 117(e)(1) of the 1939 Code, against which this net capital loss of \$50,000 is allowed in part. The remaining portion—\$29,500—may be carried forward to 1954 and 1955 since there was no net capital gain (capital gain net income for taxable years beginning after December 31, 1976) in 1954. In 1955 this \$29,500 is allowed in full against net capital gain of \$36,000, as defined by paragraph (d) of § 1.1222-1 and limited by subdivision (i) of this subparagraph.

(c) *Net capital loss of 1954.* The net capital loss is \$19,500. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains (in this case, none) from sales or exchanges of capital assets and (2) taxable income (computed without regard to capital gains and losses and the deductions provided in section 151) of \$500. This amount may be carried forward in full as a short-term loss to 1955. The net capital gain (capital gain net income for taxable years beginning after December 31, 1976) in 1955, before deduction of any carryovers, is \$36,000. (See sections 1222(9)(B) and 1212 of the Internal Revenue Code of 1954, as it existed prior to the enactment of the Revenue Act of 1964.) The \$29,500 balance of the 1952 loss is first applied against the \$36,000, leaving a balance of \$6,500. Against this amount the \$19,500 loss arising in 1954 is applied,

leaving a loss of \$13,000, which may be carried forward to 1956. Since this amount is treated as a short-term capital loss in 1956 under subdivision (i) of this subparagraph, the excess of the net long-term capital gain over the net short-term capital loss is \$2,000 (\$15,000 minus \$13,000). Half of this excess is allowable as a deduction under section 1202. Thus, after also deducting the exemption allowed as a deduction under section 151 (\$600), the taxpayer has a taxable income of \$900 (\$2,500 minus \$1,600) for 1956.

(2) *Corporations sustaining foreign expropriation capital losses for taxable years ending after December 31, 1958—(i) In general.* A corporation sustaining a net capital loss for any taxable year ending after December 31, 1958, any portion of which is attributable to a foreign expropriation capital loss, shall carry over such portion of the loss to each of the ten succeeding taxable years and treat it in each of such succeeding taxable years as a short-term capital loss to the extent and consistent with the manner provided in subparagraph (1) of this paragraph. For such purposes, the portion of any net capital loss for any taxable year which is attributable to a foreign expropriation capital loss is the amount, not in excess of the net capital loss for such year, of the foreign expropriation capital loss for such year. The portion of a net capital loss for any taxable year which is attributable to a foreign expropriation capital loss shall be treated as a separate net capital loss for that year and shall be applied, after first applying the remaining portion of such

net capital loss, to offset any capital gain net income (net capital gain for taxable years beginning before January 1, 1977) in a succeeding taxable year. In applying net capital losses of two or more taxable years to offset the capital gain net income (net capital gain(s) for taxable years beginning before January 1, 1977) of a subsequent taxable year, such net capital losses shall be offset against such capital gain net income (net capital gain(s) for taxable years beginning before January 1, 1977) in the order of the taxable years in which the losses were sustained, beginning with the loss for the earliest preceding taxable year, even though one or more of such net capital losses are attributable in whole or in part to a foreign expropriation capital loss.

(ii) *Foreign expropriation capital loss defined.* For purposes of this subparagraph the term *foreign expropriation capital loss* means, for any taxable year, the sum of the losses taken into account in computing the net capital loss for such year which are:

(a) Losses sustained directly by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing, or

(b) Losses (treated under section 165 (g)(1) as losses from the sale or exchange of capital assets) from securities which become worthless by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing.

(iii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. X, a domestic corporation which uses the calendar year as the taxable year, owns as a capital asset 75 percent of the outstanding stock of Y, a foreign corporation operating in a foreign country. In 1961, the foreign country seizes all of the assets of Y, rendering X's stock in Y worthless and thus causing X to sustain a \$40,000 foreign expropriation capital loss for such year. In 1961, X has \$30,000 of other losses from the sale or exchange of capital assets and \$50,000 of gains from the sale or exchange of capital assets. X's net capital loss for 1961 is \$20,000

(\$70,000 - \$50,000). Since the foreign expropriation capital loss exceeds this amount, the entire \$20,000 is a foreign expropriation capital loss for 1961.

Example 2. Z, a domestic corporation which uses the calendar year as the taxable year, has a net capital loss of \$50,000 for 1961, \$30,000 of which is attributable to a foreign expropriation capital loss. Pursuant to the provisions of this paragraph, \$30,000 of such net capital loss shall be carried over as a short-term capital loss to each of the 10 taxable years succeeding 1961, and the remaining \$20,000 of the net capital loss shall be carried over as a short-term capital loss to each of the 5 taxable years succeeding 1961. Z has a \$35,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (determined without regard to any capital loss carryover) for 1962. In offsetting the \$50,000 capital loss carryover from 1961 against the \$35,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1962, the \$30,000 portion of such carryover which is attributable to the foreign expropriation capital loss for 1961 is applied against the 1962 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) after applying the \$20,000 remaining portion of the carryover. Thus, there is a capital loss carryover of \$15,000 to 1963, all of which is attributable to the foreign expropriation capital loss for 1961. Z has a net capital loss for 1963 of \$10,000, no portion of which is attributable to a foreign expropriation capital loss. For 1964, Z has a net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of \$22,000 (determined without regard to the capital loss carryovers from 1961 and 1963). In offsetting the capital loss carryovers from 1961 and 1963 against Z's \$22,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1964, the \$15,000 carryover from 1961 is applied against the 1964 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) before the \$10,000 capital loss carryover from 1963 is applied against such gain. Thus, \$3,000 of the 1963 net capital loss remains to be carried over to 1965.

(3) *Regular net capital loss sustained by a corporation for taxable years beginning after December 31, 1969—(i) General rule.* A corporation sustaining a net capital loss for any taxable year beginning after December 31, 1969 (hereinafter in this paragraph referred to as the *loss year*), shall:

(a) Carry back such net capital loss to each of the 3 taxable years preceding the loss year, but only to the extent

that such net capital loss is not attributable to a foreign expropriation capital loss and the carryback of such net capital loss does not increase or produce a net operating loss (as defined in section 172(c)) for the taxable year to which it is carried back; and

(b) Carry over such net capital loss to each of the 5 taxable years succeeding the loss year,

and, subject to subdivision (ii) of this subparagraph, treat such net capital loss in each of such 3 preceding and 5 succeeding taxable years as a short-term capital loss.

(ii) *Amount treated as a short-term capital loss in each year.* The entire amount of the net capital loss for any loss year shall be carried to the earliest of the taxable years to which such net capital loss may be carried, and the portion of such net capital loss which shall be carried to each of the other taxable years to which such net capital loss may be carried shall be the excess, if any, of such net capital loss over the total of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (computed without regard to the capital loss carryback from the loss year or any taxable year thereafter) for each of the prior taxable years to which such net capital loss may be carried.

(iii) *Special rules.* (a) In the case of a net capital loss which is not a foreign expropriation capital loss and which cannot be carried back in full to a preceding taxable year by reason of section 1212(a)(1)(A)(ii) and subdivision (i)(a) of this subparagraph because such loss would produce or increase a net operating loss in such preceding taxable year, the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such preceding taxable year shall in no case be treated as greater than the amount of such net capital loss which can be carried back to such preceding taxable year upon the application of section 1212(a)(1)(A)(ii) and subdivision (i)(a) of this subparagraph.

(b) For the rules applicable to the portion of a net capital loss of a corporation which is attributable to a foreign expropriation capital loss sustained in a taxable year beginning after December 31, 1958, see section

1212(a)(2) and subparagraph (2) of this paragraph.

(c) Section 1212(a)(1)(A) and subdivision (i)(a) of this subparagraph shall not apply to (and no carryback shall be allowed with respect to) the net capital loss of a corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S. See § 1.1372-1.

(d) A net capital loss of a corporation for a year for which it is not an electing small business corporation under subchapter S shall not be carried back under section 1212(a)(1)(A) and subdivision (i)(a) of this subparagraph to a taxable year for which such corporation is an electing small business corporation. See section 1212(a)(3).

(e) A net capital loss of a corporation shall not be carried back under section 1212(a)(1)(A) and subdivision (i)(a) of this subparagraph to a taxable year for which the corporation was a foreign personal holding company, a regulated investment company, or a real estate investment trust, or for which an election made by the corporation under section 1247 is applicable. See section 1212(a)(4).

(f) A taxable year to which a net capital loss of a corporation cannot, by reason of (d) or (e) of this subdivision, be carried back under section 1212(a)(1)(A) and subdivision (i)(a) of this subparagraph shall nevertheless be treated as 1 of the 3 taxable years preceding the loss year for purposes of section 1212(a)(1)(A) and such subdivision (i)(a); but any capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such taxable year to which such net capital loss cannot be carried back shall be disregarded for purposes of subdivision (ii) of this subparagraph.

(g) A regulated investment company (as defined in section 851) sustaining a net capital loss shall carry over that loss to each of the 8 taxable years succeeding the loss year. However, the 8-year period prescribed in the preceding sentence shall be reduced (but not to less than 5 years) by the sum of (1) the number of taxable years to which the net capital loss must be carried back pursuant to subdivision (i)(a) of this subparagraph (as limited by subdivision (iii)(e) of this subparagraph) and

(2) the number of taxable years, of the 8 taxable year succeeding the loss year, that the corporation failed to qualify as a regulated investment company as defined in section 851. This subdivision shall not extend the carryover period prescribed in subdivision (i)(b) of this subparagraph to a year in which a corporation is not a regulated investment company as defined in section 851.

(iv) The application of this subparagraph may be illustrated by the following examples, in each of which it is assumed that the corporation is not, and never has been, a corporation described in subdivision (iii) (c) or (d) of this subparagraph, that the corporation files its tax returns on a calendar year basis, and that no capital loss sustained is a foreign expropriation capital loss:

Example 1. A corporation has a net capital loss for 1970 which section 1212(a)(1)(A) permits to be carried back. The entire net capital loss for 1970 may be carried back to 1967, but only to the extent that a net operating loss for 1967 would not be produced or increased. The amount of the carryback to 1968 is the excess of the net capital loss for 1970 over the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1967, computed without

regard to a capital loss carryback from 1970 or any taxable year thereafter. The amount of the carryback to 1969 is the excess of the net capital loss for 1970 over the sum of the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) for 1967 and 1968, computed without regard to a capital loss carryback from 1970 or any taxable year thereafter. The amount of the carryover to 1971 is the excess of the net capital loss for 1970 over the sum of the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) for 1967, 1968, and 1969, computed without regard to a capital loss carryback from 1970 or any taxable year thereafter. Similarly, the amount of the carryover to 1972, 1973, 1974, and 1975, respectively, is the excess of the net capital loss for 1970 over the sum of the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) for taxable years prior to 1972, 1973, 1974, or 1975, as the case may be, to which the net capital loss for 1970 may be carried, computed without regard to a capital loss carryback from 1970 or any year thereafter.

Example 2. For the taxable years 1967 to 1975, inclusive, a corporation is assumed to have net capital loss, net capital gain (capital gain net income for taxable years beginning after December 31, 1976), and taxable income (computed without regard to capital gains and losses) as follows:

	1967	1968	1969	1970	1971	1972	1973	1974	1975
Taxable income (computed without regard to capital gains or losses)	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000
Net capital loss			(1,000)	(29,500)	(16,000)	(500)			
Net capital gain (capital gain net income for taxable years beginning after December 31, 1976) (computed without regard to carrybacks or carryovers)	14,000	16,000					8,000	7,500	6,500
Carryback or carryover:									
From 1969							(1,000)		
From 1970	(14,000)	(15,500)							
From 1971		(500)					(7,000)	(7,500)	(1,000)
From 1972									(500)

The net capital loss of 1969, under the rules of subparagraph (1) of this paragraph, may not be carried back. Thus, the net capital loss for 1970 is carried back and partially absorbed by the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for 1967, and a portion of the net capital losses of both 1970 and 1971 are carried back to 1968. The net capital loss for 1969 is the oldest that may be carried to 1973, and thus, it is the first carried over and absorbed by the net capital gain for 1973. The net capital loss for 1972 (which is not carried

back because of the net capital losses in the 3 years preceding 1972) may be carried over to 1973.

Example 3. For the taxable years 1967 to 1970, inclusive, a corporation which was organized on January 1, 1967, realized operating income and net capital gains (capital gain net income for taxable years beginning after December 31, 1976) and sustained operating losses and net capital losses as follows:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	\$20,000	\$24,000
1968	20,000	0
1969	20,000	0
1970	(25,000)	(20,000)

The net capital loss of \$20,000 for 1970 is carried back to 1967 and applied against the \$24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year, reducing such net capital gain (capital gain net income for taxable years beginning after December 31, 1976) to \$4,000. The net operating loss of \$25,000 for 1970 is then carried back to 1967 and applied first to eliminate the \$20,000 of operating income for that year and then to eliminate the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for that year of \$4,000 (as reduced by the 1970 capital loss carryback).

Example 4. Assume the same facts as in Example 3 but substitute the following figures:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	(\$20,000)	\$24,000
1968	20,000	0
1969	20,000	0
1970	(25,000)	(20,000)

The net capital loss of \$20,000 for 1970 is carried back to 1967 and applied against the \$24,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year only to the extent of \$4,000, the maximum amount to which the 1970 capital loss carryback can be applied without producing a net operating loss for 1967. The unused \$16,000 balance of the 1970 net long-term capital loss can be carried forward to 1971 and subsequent taxable years to the extent provided in subdivision (i) (b) of this subparagraph.

Example 5. Assume the same facts as in Example 3 but substitute the following figures:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	0	0
1968	(\$20,000)	0
1969	0	\$24,000
1970	20,000	(24,000)

The net capital loss of \$24,000 for 1970 is carried back to 1969 and applied against the \$24,000 net capital gain (capital gain net income for taxable years beginning after De-

cember 31, 1976) realized in that year to the extent of \$24,000. The application of the capital loss carryback is not limited as it was in Example 4 because such carryback neither increases nor produces a net operating loss, as such, for 1969. The \$20,000 net operating loss for 1968 is then carried forward to 1970 to eliminate the \$20,000 of operating income for that year.

Example 6. Assume the same facts as in Example 3 but substitute the following figures:

	Operating income or loss (exclusive of capital gain or loss)	Capital gain or loss
1967	0	0
1968	0	0
1969	(\$20,000)	(\$24,000)
1970	20,000	20,000

The net capital loss of \$24,000 for 1969 is carried forward to 1970 and applied against the \$20,000 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) realized in that year. The unused \$4,000 balance of the 1969 net capital loss can be carried forward to 1971 and subsequent taxable years to the extent provided in subdivision (i) (b) of this subparagraph.

(b) *Taxpayers other than corporations for taxable years beginning after December 31, 1963*—(1) *In general.* If a taxpayer other than a corporation sustains a net capital loss for any taxable year beginning after December 31, 1963, the portion thereof which is a short-term capital loss carryover shall be carried over to the succeeding taxable year and treated as a short-term capital loss sustained in such succeeding taxable year, and the portion thereof which constitutes a long-term capital loss carryover shall be carried over to the succeeding taxable year and treated as a long-term capital loss sustained in such succeeding taxable year. The carryovers are included in the succeeding taxable year in the determination of the amount of the short-term capital loss, the net short-term capital gain or loss, the long-term capital loss, and the net long-term capital gain or loss in such year, the net capital loss in such year, and the capital loss carryovers from such year. For purposes of this subparagraph:

(i) A short-term capital loss carryover is the excess of the net short-term capital loss for the taxable year over the net long-term capital gain for such year, and

(ii) A long-term capital loss carryover is the excess of the net long-term capital loss for the taxable year over the net short-term capital gain for such year.

(2) *Special rules for determining a net short-term capital gain or loss for purposes of carryover*—(i) *Taxable years beginning after December 31, 1963, and before January 1, 1970.* In determining a net short-term capital gain or loss of a taxable year beginning after December 31, 1963, and before January 1, 1970, for purposes of computing a short-term or long-term capital loss carryover to the succeeding taxable year, an amount equal to the additional allowance deductible under section 1211(b) for the taxable year (determined as provided in section 1211(b), as in effect for taxable years beginning before January 1, 1970, and § 1.1211-1(b)(5)) is treated as a short-term capital gain occurring in such year.

(ii) *Taxable years beginning after December 31, 1969.* In determining a net short-term capital gain or loss of a taxable year beginning after December 31, 1969:

(a) For purposes of computing a short-term capital loss carryover to the succeeding taxable year, an amount equal to the additional allowance for the taxable year (determined as provided in section 1211(b) and § 1.1211-1(b)(2)) is treated as a short-term capital gain occurring in such year, and

(b) For purposes of computing a long-term capital loss carryover to the succeeding taxable year, an amount equal to the sum of the additional allowance for the taxable year (determined as provided in section 1211(b) and § 1.1211-1(b)(2)), plus the excess of such additional allowance over the net short-term capital loss (determined without regard to section 1212(b)(2) for such year) is treated as a short-term capital gain in such year.

The rules provided in this subdivision are for the purpose of taking into account the additional allowance deductible for the current taxable year under section 1211(b) and § 1.1211-1(b)(2) in determining the amount and character of capital loss carryovers from the current taxable year to the succeeding taxable year. Their practical applica-

tion to a determination of the amount and character of capital loss carryovers from the current taxable year to the succeeding taxable year involves identification of the net long-term and net short-term capital loss components of the additional allowance deductible in the current taxable year as provided by § 1.1211-1(b)(2)(iii). To the extent that the additional allowance is composed of net short-term capital losses, such losses are treated as a short-term capital gain in the current taxable year in determining the capital loss carryovers to the succeeding year. To the extent that the additional allowance is composed of net long-term capital losses applied pursuant to the provisions of § 1.1211-1(b)(2)(iii), an amount equal to twice the amount of such component of the additional allowance is treated as a short-term capital gain in the current taxable year. See paragraph (4) of this section for transitional rules if any part of the additional allowance is composed of net long-term capital losses carried to the current taxable year from a taxable year beginning before January 1, 1970.

(3) *Transitional rule for net capital losses sustained in a taxable year beginning before January 1, 1964.* A taxpayer other than a corporation sustaining a net capital loss for any taxable year beginning before January 1, 1964, shall treat as a short-term capital loss in the first taxable year beginning after December 31, 1963, any amount which would be treated as a short-term capital loss in such year under subchapter P of chapter 1 of the Code as in effect immediately before the enactment of the Revenue Act of 1964.

(4) *Transitional rule for net long-term capital losses sustained in a taxable year beginning before January 1, 1970.* In the case of a net long-term capital loss sustained by a taxpayer other than a corporation in a taxable year beginning prior to January 1, 1970 (referred to in this section as a *pre-1970 taxable year*) which is carried over and treated as a long-term capital loss in the first taxable year beginning after December 31, 1969 (referred to in this section as a *post-1969 taxable year*), the transitional additional allowance deductible under section 1211(b) for the taxable year shall be determined by application of

section 1211(b) as in effect for pre-1970 taxable years and § 1.1211-1(b)(3), and the amount of such long-term capital loss carried over and treated as a long-term capital loss in the succeeding taxable year shall be determined by application of section 1212(b)(1) as in effect for pre-1970 taxable years and subparagraph (2)(i) of this paragraph (instead of under sections 1211(b) and 1212(b)(1) as in effect for post-1969 taxable years and § 1.1211-1(b)(2) and subparagraph (2)(ii) of this paragraph, respectively) but only to the extent that such pre-1970 long-term capital loss constitutes a *transitional net long-term capital loss component* (determined as provided in § 1.1211-1(b)(3)(ii)) in the taxable year to which such pre-1970 long-term capital loss is carried. Thus, for purposes of paragraph (2) of this section, to the extent that a component of the transitional additional allowance deductible for a post-1969 taxable year under section 1211(b) and § 1.1211-1(b)(3)(i) is a transitional net long-term capital loss component carried over to such post-1969 taxable year, such component shall be treated as a short-term capital gain in determining the amount and character of capital loss carryovers from such post-1969 taxable year to the succeeding taxable year. Such component shall be so treated as a short-term capital gain in full on a dollar-for-dollar basis and shall not be doubled for this purpose as is provided by subdivision (ii) of paragraph (2) of this section in the case of a component of the additional allowance made up of net long-term capital losses applied pursuant to the provisions of § 1.1211-1(b)(2)(iii). The transitional rule provided in this paragraph does not apply to a determination of the character of capital losses (as long-term or short-term) actually deductible for the current taxable year under section 1211(b) and § 1.1211-1(b).

(5) *Examples.* The application of this paragraph can be illustrated by the following examples:

Example 1. For the taxable year 1971, an unmarried individual has taxable income for purposes of section 1211(b) of \$8,000, a long-term capital loss of \$2,000, and no other capital gains or losses. \$1,000 (one-half) of the net long-term capital loss is deductible in 1971 as the additional allowance deductible under section 1211(b). No amount of capital

loss remains to be carried over to the succeeding taxable year.

Example 2. For the taxable year 1972, the same unmarried individual has taxable income for purposes of section 1211(b) of \$8,000, a long-term capital loss of \$3,000 and no other capital gains or losses. \$1,500 (one-half of the excess net capital loss) is deductible in 1972, but limited to the \$1,000 maximum additional allowance deductible under section 1211(b). By application of section 1212(b)(1), he will carry over to 1973 a long-term capital loss of \$1,000 determined as follows:

Net long-term capital loss	(\$3,000)
Additional allowance deductible under section 1211(b)	\$1,000
Excess of additional allowance over net short-term capital loss (determined without regard to section 1212(b)(2)(B)(i))	1,000
Total amount treated as short-term capital gain under 1212(b)(2)(B) for purposes of determining carryover	2,000
Long-term capital loss carryover to 1973	(1,000)

If, in 1973, he had taxable income for purposes of section 1211(b) of \$8,000, but no capital gains or losses, \$500 (one-half) of the net long-term capital loss carryover from 1972 would be deductible in 1973 as the additional allowance deductible under section 1211(b). No amount of capital loss would be carried over to 1974.

Example 3. For the taxable year 1971, an unmarried individual has taxable income for purposes of section 1211(b) of \$9,000, a \$500 short-term capital gain, a \$700 short-term capital loss, a \$1,000 long-term capital gain and a \$1,700 long-term capital loss. He will offset \$1,500 of capital losses against capital gains. The excess net capital loss of \$900 is deductible in 1971 to the extent of a \$550 additional allowance deductible under 1211(b) which is smaller than both \$1,000 and taxable income for purposes of section 1211(b), determined as follows:

Losses allowed to the extent of gains	(\$1,500)
Amount allowed under section 1211(b)(1)(C):	
(i) Excess of net short-term capital loss over net long-term capital gain	(200)
(ii) One-half of the excess of net long-term capital loss over net short-term capital gain	(350)
Additional allowance deductible under section 1211(b)	550

The total amount treated as short-term capital gain under section 1212(b)(2)(B) for purposes of determining any carryover to the succeeding taxable year exceeds \$900. No amount of net capital loss remains to be carried over to the succeeding taxable year.

Example 4. If in example (3) above, the long-term capital loss had been \$2,800, the taxpayer would carry over \$200 of long-term capital loss to 1972, determined as follows:

Losses allowed to extent of gains	(\$1,500)
Amount allowed under section 1211(b)(1) (B) and (C):	
(i) Excess of net short-term capital loss over net long-term capital gain	(200)
(ii) One-half the excess of net long-term capital loss over net short-term capital gain	(900)
as limited by 1211(b)(1)(B) to an additional allowance of \$1,000.	
Carryover under section 1212(b)(1):	
Net long-term capital loss for 1971	(\$1,800)
Additional allowance under section 1211(b)(1)(B)	1,000
Excess of additional allowance deductible under section 1211(b) over net short-term capital loss determined without regard to section 1212(b)(2)(B)(i) (\$1,000 less \$200)	800
Total amount treated as short-term capital gain under section 1212(b)(2)(B) for purposes of determining carryover	1,800
Short-term capital gain for 1971	500
Total short-term capital gain	2,300
Short-term capital loss for 1971	(700)
Net short-term capital gain	1,600
Long-term capital loss carryover (\$1,800 less \$1,600)	200

Example 5. For 1969, an unmarried individual has taxable income for purposes of section 1211(b) of \$8,000, a long-term capital loss of \$3,000, and no other capital gains or losses. He is allowed to deduct in 1969 \$1,000 as the additional allowance deductible under section 1211(b) (as in effect for pre-1970 taxable years) and to carry over to 1970, a long-term capital loss of \$2,000 under section 1212(b) (as in effect for pre-1970 taxable years).

If, in 1970, the same unmarried individual with taxable income for purposes of section 1211(b) of \$8,000, has no capital gains or losses, he would deduct \$1,000 of his pre-1970 capital loss carryover as the transitional additional allowance deductible under section 1211(b) (as in effect for pre-1970 years) and carry over under section 1212(b)(1) (as in effect for pre-1970 taxable years) to 1971 the remaining \$1,000 as a pre-1970 long-term capital loss.

If, in 1970, the same individual instead has a long-term capital gain of \$2,500, and a long-term capital loss of \$1,500, he would net these two items with the \$2,000 carried to 1970 as a long-term capital loss. Thus, he would have a net long-term capital loss for 1970 of \$1,000 which is deductible in 1970 as the transitional additional allowance deductible under section 1211(b). He would have no amount to carry over under section 1212(b)(1) to 1971.

If, in 1970, the same individual instead has a long-term capital loss of \$1,200, and a long-term capital gain of \$200, resulting in a net long-term capital loss of \$3,000 when netted with the \$2,000 carried to 1970 as a long-term capital loss, he would deduct \$1,000 in respect of his pre-1970 long-term capital loss carryover as the transitional additional allowance deductible under section 1211(b) (as in effect for pre-1970 taxable years) and carry over under section 1212(b)(1) (as in effect for pre-1970 taxable years) to 1971 the remaining \$1,000 of the pre-1970 component of his long-term capital loss carryover, and the \$1,000 net long-term capital loss actually sustained in 1970 as the second component of his long-term capital loss carryover.

Example 6. For 1970 a married individual filing a separate return has taxable income of \$8,000, a long-term capital loss of \$3,500 and a short-term capital gain of \$3,000. He also has a pre-1970 short-term capital loss of \$2,000 which is carried to 1970. The \$3,000 short-term capital gain realized in 1970 would first be reduced by the \$2,000 short-term capital loss carryover, and then the remaining \$1,000 balance of the short-term capital gain would be offset against the \$3,500 long-term capital loss, producing a net long-term capital loss of \$2,500, no part of which is a net long-term capital loss carried over from 1969. However, under the special rule of § 1.1211-1(b)(7)(ii) in 1970, the taxpayer would deduct as the additional allowance deductible under section 1211(b), the \$500 limitation in § 1.1211-1(b)(2)(ii) in the case of a married taxpayer filing a separate return in a taxable year ending after December 31, 1969, plus the *transitional net short-term capital loss component* of \$2,000 computed under § 1.1211-1(b)(3)(iv), but limited to a total deduction of \$1,000. The \$1,000 additional allowance deductible under section 1211(b) would absorb \$2,000 of the \$2,500 net long-term capital loss, and he would carry the unused \$500 balance of such loss to 1971 for use in that year.

Example 7. For 1970, an unmarried individual filing a separate return has taxable income for purposes of section 1211(b) of \$8,000, and a long-term capital loss of \$2,000. He also has a pre-1970 long-term capital loss of \$2,500 which is carried to 1970. In 1970, the taxpayer would deduct as the transitional additional allowance deductible under section 1211(b) \$1,000, absorbing \$1,000 of the pre-1970 long-term capital loss of \$2,500. He would carry to 1971 the unused \$1,500 balance of his pre-1970 long-term capital loss plus the 1970 long-term capital loss of \$2,000, or a total of \$3,500, for use in 1971.

For 1971, the same taxpayer filing a separate return with taxable income for purposes of section 1211(b) of \$8,000, has a \$3,600 long-term capital gain and a \$2,200 long-term capital loss. When these gains and losses are combined with the long-term capital loss carryover from 1970 of \$3,500, a net long-term

capital loss of \$2,100 results. He would deduct \$1,000 as the transitional additional allowance deductible under section 1211(b). The \$1,000 additional allowance would absorb \$100 of the unused pre-1970 long-term capital loss carryover of \$1,500 plus \$1,800 of the unused post-1969 long-term capital loss carryover of \$2,100 (the amount of the 1971 net long-term capital loss necessary to make up the remaining \$900 balance of the additional allowance). Although a component of the 1971 net long-term capital loss is the unused pre-1970 long-term capital loss carryover of \$1,500, only \$100 of this carryover is available for use in full on a dollar-for-dollar basis in computing the transitional additional allowance for 1971 since it only exceeds by that amount the \$1,400 net capital gain (capital gain net income for taxable years beginning after December 31, 1976) actually realized in 1971 all of which is net long-term capital gain (long-term capital gain of \$3,600 reduced by long-term capital loss of \$2,200). See § 1.1221-1(b)(3)(ii). The taxpayer would carry over to 1972 as a long-term capital loss the remaining \$200 of the 1971 long-term capital loss.

Example 8. For 1970, an unmarried individual has taxable income for purposes of section 1211(b) of \$8,000 and a short-term capital loss of \$700. He also has a pre-1970 long-term capital loss carryover of \$1,200. He would deduct \$1,000 as the transitional additional allowance deductible under section 1211(b). The \$1,000 transitional additional allowance would be composed of the 1970 short-term capital loss of \$700 and \$300 of the pre-1970 long-term capital loss carryover. He would carry over to 1971 the unused \$900 balance of his \$1,200 pre-1970 long-term capital loss carryover for use in 1971.

(c) *Husband and wife.* (1) The following rules shall be applied in computing capital loss carryovers by husband and wife:

(i) If a husband and wife making a joint return for any taxable year made separate returns for the preceding year, any capital loss carryovers of each spouse from such preceding taxable year may be carried forward to the taxable year in accordance with paragraph (a) or (b) of this section.

(ii) If a joint return was made for the preceding taxable year, any capital loss carryover from such preceding taxable year may be carried forward to the taxable year in accordance with paragraph (a) or (b) of this section.

(iii) If a husband and wife make separate returns for the first taxable year beginning after December 31, 1963, or any prior taxable year, and they made

a joint return for the preceding taxable year, any capital loss carryover from such preceding taxable year shall be allocated to the spouses on the basis of their individual net capital loss which gave rise to such capital loss carryover. The capital loss carryover so allocated to each spouse may be carried forward by such spouse to the taxable year in accordance with paragraph (a) or (b) of this section.

(iv) If a husband and wife making separate returns for any taxable year following the first taxable year beginning after December 31, 1963, made a joint return for the preceding taxable year, any long-term or short-term capital loss carryovers shall be allocated to the spouses on the basis of their individual net long-term and net short-term capital losses for the preceding taxable year which gave rise to such capital loss carryovers, and the portions of the long-term or short-term capital loss carryovers so allocated to each spouse may be carried forward by such spouse to the taxable year in accordance with paragraph (b) of this section.

(v) If separate returns are made both for the taxable year and the preceding taxable year, any capital loss carryover of each spouse may be carried forward by such spouse in accordance with paragraph (a) or (b) of this section.

(2) The provisions of subparagraph (1) (i), (iii), and (iv) of this paragraph may be illustrated by the following examples:

Example 1. If H and W, husband and wife, make a joint return for 1955, having made separate returns for 1954 in which H had a net capital loss of \$3,000 and W had a net capital loss of \$2,000, in their joint return for 1955 they would have a short-term capital loss of \$5,000 (the sum of their separate capital loss carryovers from 1954), allowable in accordance with paragraph (a) of this section. If, on the other hand, they make separate returns in 1955 following a joint return in 1954 in which their net capital loss was \$5,000 allocable \$3,000 to H and \$2,000 to W, the carryover of H as a short-term capital loss for the purpose of his 1955 separate return would be \$3,000 and that of W for her separate return would be \$2,000, each allowable in accordance with paragraph (a) of this section.

Example 2. H and W, husband and wife, make separate returns for 1966 following a

joint return for 1965. The capital gains and losses incurred by H and W in 1965, including those carried over by them to 1965, were as follows:

	H	W
Long-term capital gains	\$8,000	\$9,000
Long-term capital losses	(15,000)	(6,000)
Short-term capital gains	10,000	4,000
Short-term capital losses	(19,000)	(5,000)

Thus, in 1965 H and W had a net capital loss of \$14,000 on their joint return. Of this amount, \$4,000 was a long-term capital loss carryover, and \$10,000 was a short-term capital loss carryover, determined in accordance paragraph (b) of this section. H's net long-term capital loss was \$7,000 for 1965. This amount was offset on the joint return by W's net long-term capital gain of \$3,000. Thus, H may carry over to his separate return for 1966, a long-term capital loss carryover of \$4,000. H and W may carry over to their separate returns for 1966, as short-term capital loss carryovers, the amounts of their respective net short-term losses from 1965, \$9,000 and \$1,000.

[T.D. 6828, 30 FR 7806, June 17, 1965, as amended by T.D. 6867, 30 FR 15095, Dec. 7, 1965; T.D. 7301, 39 FR 968, Jan. 4, 1974; 39 FR 2758, Jan. 24, 1974; T.D. 7659, 44 FR 73019, Dec. 17, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

GENERAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

§ 1.1221-1 Meaning of terms.

(a) The term *capital assets* includes all classes of property not specifically excluded by section 1221. In determining whether property is a *capital asset*, the period for which held is immaterial.

(b) Property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 167 and real property used in the trade or business of a taxpayer is excluded from the term *capital assets*. Gains and losses from the sale or exchange of such property are not treated as gains and losses from the sale or exchange of capital assets, except to the extent provided in section 1231. See § 1.1231-1. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term *capital assets* even though depreciation may have been allowed with respect to such property under section 23(l) of the Internal Revenue Code of 1939 before its amendment by section 121(c) of the Revenue Act of 1942 (56

Stat. 819). However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code.

(c)(1) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term *capital assets* if held by a taxpayer whose personal efforts created such property, or if held by a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer whose personal efforts created such property. For purposes of this subparagraph, the phrase *similar property* includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.

(2) In the case of sales and other dispositions occurring after July 25, 1969, a letter, a memorandum, or similar property is excluded from the term *capital asset* if held by (i) a taxpayer whose personal efforts created such property, (ii) a taxpayer for whom such property was prepared or produced, or (iii) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer described in subdivision (i) or (ii) of this subparagraph. In the case of a collection of letters, memorandums, or similar property held by a person who is a taxpayer described in subdivision (i), (ii), or (iii) of this subparagraph as to some of such letters, memorandums, or similar property but not as to others, this subparagraph shall apply only to those letters, memorandums, or similar property as to which such person is a taxpayer described in such subdivision. For purposes of this subparagraph, the phrase

similar property includes, for example, such property as a draft of a speech, a manuscript, a research paper, an oral recording of any type, a transcript of an oral recording, a transcript of an oral interview or of dictation, a personal or business diary, a log or journal, a corporate archive, including a corporate charter, office correspondence, a financial record, a drawing, a photograph, or a dispatch. A letter, memorandum, or property similar to a letter or memorandum, addressed to a taxpayer shall be considered as prepared or produced for him. This subparagraph does not apply to property, such as a corporate archive, office correspondence, or a financial record, sold or disposed of as part of a going business if such property has no significant value separate and apart from its relation to and use in such business; it also does not apply to any property to which subparagraph (1) of this paragraph applies (i.e., property to which section 1221(3) applied before its amendment by section 514(a) of the Tax Reform Act of 1969 (83 Stat. 643)).

(3) For purposes of this paragraph, in general, property is created in whole or in part by the personal efforts of a taxpayer if such taxpayer performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs and guides others in the performance of such work. A taxpayer, such as corporate executive, who merely has administrative control of writers, actors, artists, or personnel and who does not substantially engage in the direction and guidance of such persons in the performance of their work, does not create property by his personal efforts. However, for purposes of subparagraph (2) of this paragraph, a letter or memorandum, or property similar to a letter or memorandum, which is prepared by personnel who are under the administrative control of a taxpayer, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him.

(4) For the application of section 1231 to the sale or exchange of property to which this paragraph applies, see

§ 1.1231-1. For the application of section 170 to the charitable contribution of property to which this paragraph applies, see section 170(e) and the regulations thereunder.

(d) Section 1221(4) excludes from the definition of *capital asset* accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

(e) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term *capital assets*. An obligation may be issued on a discount basis even though the price paid exceeds the face amount. Thus, although the Second Liberty Bond Act (31 U.S.C. 754) provides that United States Treasury bills shall be issued on a discount basis, the issuing price paid for a particular bill may, by reason of competitive bidding, actually exceed the face amount of the bill. Since the obligations of the type described in this paragraph are excluded from the term *capital assets*, gains or losses from the sale or exchange of such obligations are not subject to the limitations provided in such subchapter P. It is, therefore, not necessary for a taxpayer (other than a life insurance company taxable under part I (section 801 and following), subchapter L, chapter 1 of the Code, as amended by the Life Insurance Company Tax Act of 1955 (70 Stat. 36), and, in the case of taxable years beginning before January 1, 1955, subject to taxation only on interest, dividends, and

rents) to segregate the original discount accrued and the gain or loss realized upon the sale or other disposition of any such obligation. See section 454(b) with respect to the original discount accrued. The provisions of this paragraph may be illustrated by the following examples:

Example 1. A (not a life insurance company) buys a \$100,000, 90-day Treasury bill upon issuance for \$99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for \$99,999.50. The entire net gain to A of \$1.50 may be taken into account as a single item of income, without allocating \$1 to interest and \$0.50 to gain. If B holds the bill until maturity his net gain of \$0.50 may similarly be taken into account as a single item of income, without allocating \$1 to interest and \$0.50 to loss.

Example 2. The facts in this example are the same as in example (1) except that the selling price to B is \$99,998.50. The net gain to A of \$0.50 may be taken into account without allocating \$1 to interest and \$0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of \$1.50 may be taken into account as a single item of income without allocating \$1 to interest and \$0.50 to gain.

[T.D. 6500, 25 FR 12003, Nov. 26, 1960, as amended by T.D. 7369, 40 FR 29840, July 16, 1975]

§ 1.1221-2 Hedging transactions.

(a) *Treatment of hedging transactions—*

(1) *In general.* This section governs the treatment of hedging transactions under section 1221. Except as provided in paragraph (f)(2) of this section (and notwithstanding the provisions of § 1.1221-1(a)), the term capital asset does not include property that is part of a hedging transaction (as defined in paragraph (b) of this section).

(2) *Short sales and options.* This section also governs the character of gain or loss from a short sale or option that is part of a hedging transaction. See §§ 1.1233-2 and 1.1234-4. Except as provided in paragraph (f)(2) of this section, gain or loss on a short sale or option that is part of a hedging transaction (as defined in paragraph (b) of this section) is ordinary income or loss.

(3) *Exclusivity.* If a transaction is not a hedging transaction as defined in paragraph (b) of this section, gain or loss from the transaction is not made ordinary on the grounds that property

involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

(4) *Coordination with other sections—*(i)

Section 988. This section does not apply to determine the character of gain or loss realized on a section 988 transaction as defined in section 988(c)(1) or realized with respect to a qualified fund as defined in section 988(c)(1)(E)(iii). This section does apply, however, to transactions or payments that would be subject to section 988 but for the date that the transactions were entered into or the date that the payments were made.

(ii) *Sections 864(e) and 954(c).* Except as otherwise provided in regulations issued pursuant to sections 864(e) and 954(c), the definition of hedging transaction in paragraph (b) of this section does not apply for purposes of section 864(e) and 954(c).

(b) *Hedging transaction defined.* A hedging transaction is a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—

(1) To reduce risk of price changes or currency fluctuations with respect to ordinary property (as defined in paragraph (c)(5) of this section) that is held or to be held by the taxpayer; or

(2) To reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.

(c) *Rules of application.* The rules of this paragraph (c) apply for purposes of the definition of the term hedging transaction in paragraph (b) of this section. These rules must be interpreted reasonably and consistently with the purposes of this section. Where no specific rules of application control, the definition of hedging transaction must be interpreted reasonably and consistently with the purposes of this section.

(1) *Reducing risk—*(i) *Transactions that reduce risk.* Whether a transaction reduces a taxpayer's risk is determined

based on all of the facts and circumstances surrounding the taxpayer's business and the transaction. In general, a taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions reduce the taxpayer's risk.

(ii) *Micro and macro hedges*—(A) *In general*. A taxpayer has risk of a particular type only if it is at risk when all of its operations are considered. Nonetheless, a hedge of a particular asset or liability generally will be respected as reducing risk if it reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk of the taxpayer's operations. If a taxpayer hedges particular assets or liabilities, or groups of assets or liabilities, and the hedges are undertaken as part of a program that, as a whole, is reasonably expected to reduce the overall risk of the taxpayer's operations, the taxpayer generally does not have to demonstrate that each hedge that was entered into pursuant to the program reduces its overall risk.

(B) *Fixed-to-floating hedges*. Under the principles of paragraph (c)(1)(ii)(A) of this section, a transaction that economically converts an interest rate or price from a fixed price or rate to a floating price or rate may reduce risk. For example, if a taxpayer's income varies with interest rates, the taxpayer may be at risk if it has a fixed rate liability. Similarly, a taxpayer with a fixed cost for its inventory may be at risk if the price at which the inventory can be sold varies with a particular factor. Thus, a transaction that converts an interest rate or price from fixed to floating may be a hedging transaction.

(iii) *Written options*. A written option may reduce risk. For example, in appropriate circumstances, a written call option with respect to assets held by a taxpayer or a written put option with respect to assets to be acquired by a taxpayer may be a hedging transaction. See also paragraph (c)(1)(v) of this section.

(iv) *Extent of risk reduction*. A taxpayer may hedge all or any portion of its risk for all or any part of the period during which it is exposed to the risk.

(v) *Transactions that counteract hedging transactions*. If a transaction is entered into primarily to counteract all or any part of the risk reduction effected by one or more hedging transactions, the transaction is a hedging transaction. For example, if a written option is used to reduce or eliminate the risk reduction obtained from another position such as a purchased option, then it may be part of a hedging transaction.

(vi) *Number of transactions*. The fact that a taxpayer frequently enters into and terminates positions (even if done on a daily or more frequent basis) is not relevant to whether these transactions are hedging transactions. Thus, for example, a taxpayer hedging the risk associated with an asset or liability may frequently establish and terminate positions that hedge that risk, depending on the extent the taxpayer wishes to be hedged. Similarly, if a taxpayer maintains its level of risk exposure by entering into and terminating a large number of transactions in a single day, its transactions may nonetheless qualify as hedging transactions.

(vii) *Transactions that do not reduce risk*. A transaction that is not entered into to reduce a taxpayer's risk is not a hedging transaction. For example, assume that a taxpayer produces a commodity for sale, sells the commodity, and enters into a long futures or forward contract in that commodity in the hope that the price will increase. Because the long position does not reduce risk, the transaction is not a hedging transaction. Moreover, gain or loss on the contract is not made ordinary on the grounds that it is a surrogate for inventory. See paragraph (a)(3) of this section.

(2) *Entering into a hedging transaction*. A taxpayer may enter into a hedging transaction by using a position that was a hedge of one asset or liability to hedge another asset or liability (recycling).

(3) *No investments as hedging transactions*. If an asset (such as an investment) is not acquired primarily to reduce risk, the purchase or sale of that asset is not a hedging transaction even if the terms of the asset limit or reduce the taxpayer's risk with respect to other assets or liabilities. For example,

a taxpayer's interest rate risk from a floating rate borrowing may be reduced by the purchase of debt instruments that bear a comparable floating rate. The acquisition of the debt instruments, however, is not a hedging transaction because the transaction is not entered into primarily to reduce the taxpayer's risk. Similarly, borrowings generally are not made primarily to reduce risk.

(4) *Normal course.* Solely for purposes of paragraph (b) of this section, if a transaction is entered into in furtherance of a taxpayer's trade or business, the transaction is entered into in the normal course of the taxpayer's trade or business. This rule applies even if the risk to be reduced relates to the expansion of an existing business or the acquisition of a new trade or business.

(5) *Ordinary property and obligations—*
(i) *In general.* Except as provided in paragraph (g)(3) of this section (which contains transition rules), property is ordinary property to a taxpayer only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss regardless of the taxpayer's holding period when the sale or exchange occurs. Thus, for example, property used in a trade or business within the meaning of section 1231(b) (determined without regard to the holding period specified in that section) is not ordinary property. An obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce capital gain or loss. For purposes of the preceding sentence, termination has the same meaning as in section 1234A.

(ii) *Hedges of noninventory supplies.* Notwithstanding paragraph (c)(5)(i) of this section, if a taxpayer sells only a negligible amount of a noninventory supply, then, only for purposes of determining whether a transaction to hedge the purchase of that noninventory supply is a hedging transaction, the supply is treated as ordinary property. A noninventory supply is a supply that a taxpayer purchases for consumption in its trade or business and that is not an asset described in sections 1221(1) through (5).

(6) *Borrowings.* Whether hedges of a taxpayer's debt issuances (borrowings) are hedging transactions is determined

without regard to the use of the proceeds of the borrowing.

(7) *Hedging an aggregate risk.* The term hedging transaction includes a transaction that reduces an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only if all of the risk, or all but a de minimis amount of the risk, is with respect to ordinary property, ordinary obligations, and borrowings.

(d) *Hedging by members of a consolidated group—*(1) *General rule: single-entity approach.* For purposes of this section, the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation. For example, if any member of a consolidated group hedges the risk of another member of the group by entering into a transaction with a third party, that transaction may potentially qualify as a hedging transaction. Conversely, intercompany transactions are not hedging transactions because, when considered as transactions between divisions of a single corporation, they do not reduce the risk of that single corporation.

(2) *Separate-entity election.* In lieu of the single-entity approach specified in paragraph (d)(1) of this section, a consolidated group may elect separate-entity treatment of its hedging transactions. If a group makes this separate-entity election, the following rules apply.

(i) *Risk of one member not risk of other members.* Notwithstanding paragraph (d)(1) of this section, the risk of one member is not treated as the risk of other members.

(ii) *Intercompany transactions.* An intercompany transaction is a hedging transaction (an intercompany hedging transaction) with respect to a member of a consolidated group if and only if it meets the following requirements—

(A) The position of the member in the intercompany transaction would qualify as a hedging transaction with respect to the member (taking into account paragraph (d)(2)(i) of this section) if the member had entered into the transaction with an unrelated party; and